July 15, 2020

Dear client,

We are officially in a recession. Some expect second quarter GDP to fall by as much as 25% - 40%. At this level it would be the worst quarterly decline in US history. The unemployment rate in the US is at 11%. Some states are scaling back the re-opening of their economy as COVID cases are back on the rise. There is social and political unrest across the country.

And yet, the stock market just finished its best quarter in over 20 years with the S&P 500 up 20.54%. How could this be?

Part of the reason is due to the market cap weighting of the index. This means the larger companies have a bigger influence on performance. These larger companies include Facebook, Amazon, Netflix and Google/Alphabet, commonly referred to as the FANG stocks. As of the end of April, these four stocks alone represented roughly 12% of the index. If we add Apple and Microsoft to the list (FANGAM), the percentage increases to 22% and therefore 22% of the index's return is from just these six stocks all of which have done remarkably well in this COVID environment (most likely because COVID has accelerated the move to tech).

Since 2009, the US market has outperformed the world markets by nearly a factor of three. However, if you remove the FANGAM stocks, the S&P "494" would be up 12% which is just a bit better than the MSCI all world ex US, a purely international stock index. Year-to-date return of the current S&P 500 composition is down 6% but, if instead of weighting companies by size and each one of the 500 companies was given equal weighting, the return changes dramatically. In this format, it is down 16% for the year.

Should we be concerned that such few stocks make up a large percentage of the index? Not really. This is nothing new. Looking back at market data as far as 1927, it shows it is normal to have a top-heavy stock market. The names of the companies have changed over time of course. The great market influencers of the past included AT&T, General Motors, General Electric, IBM and Exxon. One day the FANG stocks will also be surpassed. This simply shows while the S&P 500 is a widely referenced index and measure of the US economy, it is flawed and actually not that well diversified.

It is the actions of the government that has had the biggest impact on the rising market in light of the economic turmoil. During the Great Depression, the economist John Maynard Keynes suggested government intervention through monetary or fiscal policy is necessary when the economy is functioning below its potential. This philosophy is known as Keynesian economics. Keynesian economics got us through the 2008 markets, and it is getting us through this market although it is highly controversial in some conservative economic circles. The three trillion-dollar stimulus package the government created in March was meant to "prime the pump" and it was an economic lifeline. Without the government's infusion of money, we would likely be in a depression bigger than 1929.

The stimulus has allowed most businesses to stay in business and keep employees employed. And although the unemployment number has increased, household incomes have gone up, at least temporarily. For many, wages have been replaced with unemployment aid and stimulus checks. Even with more income though, reports show individuals are not spending the money. Consumer spending has plummeted while Americans' personal savings rate has hit a record high. This is great for personal finances, but not great for the US economy that is fueled by consumer spending. To encourage spending the Fed has slashed interest rates. While lower rates will increase borrowing and therefore spending, if you are an investor lower rates make cash and bonds less attractive. As a result, investors have been transferring assets away for these low yielding investments to the stock market.

Confidence in the markets has also increased with the Fed's unveiling of new quantitative easing. The Fed has been actively buying securities to increase the money supply, support the high yield bond market and encourage investing. They are now one of the top holders of several corporate bond ETF's and have made it clear they will back-stop the capital markets. This has reduced some of the perceived risks in the markets, driving prices up.

As we have said in prior letters, the stock market is not the economy. It is forward looking. This is the worse economic downturn since the Great Depression. The government's actions have kept the economy from being far, far worse. The markets recognize this and see things getting better in the future. But we still have a long way to go. Evictions and mortgage foreclosures are on the rise and the $600 per week unemployment checks end this month. More stimulus money is needed but how much is unclear. The longer the virus persists, the deeper the cracks in the economy will grow.

A lot of uncertainty remains and with uncertainty comes volatility. The markets have come back strong from their lows in March, but it would not be surprising to see them fall back down as we navigate through this. Brace yourself. Stay seated during the turbulence. Your portfolio is robust. Our investment method is proven. We will get through this.

You will notice your quarterly reports look a bit different. That's because we have updated our portfolio management software. The new reports provide additional data to what we provided in the past. We have enclosed a description of some of the changes with the new system. You should have also received an email to activate your new client portal. The new portal provides you with up to date portfolio values and you will still be able to transfer documentation through it securely.

Lastly, the Security & Exchange (SEC) recently required all firms in our industry to provide their clients with a Client Relationship Summary, or CRS. The CRS describes the relationship and services we provide to clients. A copy of our CRS is enclosed with this letter and you can link to it from the home page on our website just under the "Who We Are" link. We will need to provide you with an additional copy each time you open a new account with us.

Jim John Richard Mary and Ryan